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ABSTRACT

Chapter 2 of the Education Consolidation and Improvement Act (ECIA) provides small amounts of relatively unrestricted federal funds to state and local agencies on a noncompetitive, formulaic basis; thus it has been hailed as the harbinger of the "new Federalism." The lack of narrow constraints and the simplified application and monitoring procedures distinguish the new Federalism from the old. A conceptual framework is provided for evaluating the effects of Chapter 2, and these concepts are then used to interpret some of its effects in Texas. The first section, "Principles of Fiscal Federalism," addresses the structure, evolution, and justification of intergovernmental transfers. Federal categorical grants have been justified on the grounds of efficiency (spillover of benefits across jurisdictions) and equity (correcting the imbalance between needs and capacities). A theoretical analysis of the effects of categorical grants follows, illustrating how the necessity for constraints is proportional to the divergence between the objectives of national and local policymakers. The second section, "Insights from Consumption Theory," assesses spending patterns as they relate to the hidden costs of categorical programs (negotiation, monitoring, and reporting) and concludes that the shift to formula-based grants will most likely increase participation. The effects of Chapter 2 in Texas are then cited to confirm these hypotheses. (TE)

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EVALUATING THE NEW FEDERALISM: IMPLEMENTATION OF ECIA CHAPTER TWO IN TEXAS

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EVALUATING THF NEW FEDERALISM: IMPLEMENTATION OF ECIA CHAPTER TWO IN TEXAS

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Chapter Two of the Education Consolidation and Improvement Act (ECIA) has been heralded as the harbinger of a new Federalism. Now in the process of implementation. it provides state and local education agencies with small amounts of funds. that are relatively unrestricted in use and that are distributed on a noncompetitive, formula basis. The lack of narrow constraints in use and the simplified application and monitoring procedures distinguishes the new Federalism from the old. The new grants are still categorical--Chapter Two funds cannot be used for road repair--but the new categories are far broader and less detailed than the old. Associated with the implementation of the New Federalism has been a decrease in the amount of Federal transfers to states and localities. Although joined as a matter of historical fact. the reduction in regulation and in funding are analytically distinct.

How can Chapter Two as an innovation be evaluated? Anecdotes, horror stories, and ideological canards will not suffice. Since Chapter Two purports to break cleanly with the past, it is appropriate to examine intergovernmental transfers in education from first principles. A conceptual framework and a set of fairly objective, operational indicators of outcome must be specified. Fortunately. such a conceptual framework is offered by the

economics of public finance, which has developed several normative and behavioral propositions about intergovernmental relations. or more specifically about fiscal federalism. This paper presents some simple, yet powerful orienting concepts. which are then used in interpreting some of the effects of Chapter Two on Texas.

PRINCIPLES OF FISCAL FEDERALISM

The rationale for intergovernmental transfers

The first question raised in public finance about intergovernmental relations is "Why should there be intergovernmental transfers?" This is not an idle question. because massive transfers from the Federal to state governments are a relatively modern phenomenon. having their origins in the National Defense Highway Program in the late 1950s. Small transfers from Federal to local government for vocational education began in 1917. but massive transfers were unleashed by the Elementary and Secondary Education Act of 1965 and expanded with "revenue sharing" enacted in the State and Local Assistance Act of 1972. Transfers from state to local governments have earlier origins. with the initiation of foundation plans from the 1920's (Benson. 1968).

The structure of intergovernmental grants can vary on at least five basic dimensions: 1) the matching percentage. 2) degree of generality-selectivity (or bloc vs. categorical or functional), 3) formula-oriented (unconditional) or project-oriented (conditional), 4) degree of relationship to need, and 5) constraints on maintenance of effort. Chapter Two has resulted in

the change along three of these dimensions: an increasing generality in the disposition of funds by program objective, item of expenditure and beneficiary class; a switch from project- to formula-orientation; and a reduction in the relationship of entitlement to need. Aside from the National Defense Education Act of 1958, Federal grants to public schools have not required matching. Since most Federal grants to local schools have been flat, this dimension warrants no further discussion here.

While the evolution of intergovernmental transfers has resulted from the political process, some justifications can be found in the normative theory of public finance. The justifications are on grounds of equity and efficiency.

There are at least two facets of the equity argument. One is based on an obvious factual premise: Low-income jurisdictions may be unable to raise as much revenues as high-income jurisdictions even if they former tax themselves at a higher rate. For example, in the mid-1970s, states like Mississippi and West Virginia taxed a higher proportion of their own incomes than Connecticut or New Jersey, yet were able to raise less money per capita as a result (Musgrave & Musgrave, 1980, Table 25-5). A second, normative premise, is that equalization of expenditures on certain public expenditures like education are desirable. The equation of equal opportunity with equal spending on schools has considerable appeal to the American public although there have been both popular and academic skeptics about the connection (Katzman, 1971). With the nearly complete interstate convergence of real income, interstate redistributions from states like New York or Michigan to rural,

Southern states--which have lower nominal incomes and lower costs of running schools--less compelling, but appealing nonetheless.

Even if states had nearly equal average incomes. there is a second equity justification for Federal grants to localities. The interests of disadvantaged minorities may not be as well represented at the state and local level as at the Federal level. Through Federal aid, these neglected interests could achieve a larger share of the pie. This was a compelling argument about Southern states until the 1960s. With the enfranchisement minorities as a result of successive Civil Rights and Voting Rights Act of the 1960s and with Federally-mandated redistricting, following Baker v. Carr, this latter justification is less compelling. The imbalance between fiscal capacity and need (or mandates) may be particularly great in certain cities, but the argument for seeking redress in Washington rather than in state capitals is not obvious in all cases.

Another twist to this argument is that the cost of aggregating interests of educational minorities. like the handicapped or the gifted, may be easier when politics is focused on Congress than upon the 50 state legislatures or the tens of thousands of local school districts. This hypothesis may be tested as a consequence of the consolidation of programs targeted at some of these educational minorities under Chapter Two.

The efficiency argument notes that in setting its own tax-expenditure mix, a state or locality does not take into account benefits that spill across its borders. The migration of poorly educated children from Mississippi to Chicago posed a

burden on Chicago that was not taken into account in Mississippi's tax-expenditure decision (Weisbrod, 1964). The high-income states clearly had a stake in educational outcomes in the poorer states.

The Heller-Pechman plan for revenue sharing in the 1960s had another justification which seems anachronistic today (Heller. 1966). In the 1960s, the dominant Keynesian economists had such a buoyant view of national economic prospects that an impending problem was seen as a perpetual budget surplus. As an incomes rose the progressive Federal income tax would extract an increasing proportion of national income, which unless spent would provide a "fiscal drag" on demand. The Galbraithian view that public expenditures were more meritorious than private ones predominated, for the Keynesians in the late 1960s were not proposing tax cuts like the "supply-siders" of the 1980s, but transfers of this potential budget surplus to states and localities. Such a transfer was seen as more desirable than a tax cut-cum-increases in state and local taxes because the Federal tax structure was viewed as superior in progressivity. States and localities were viewed as being less than competent in assessing their own fiscal needs. much less needs that redounded to the benefit of the communities beyond their border.

In sum, Federal categorical grants programs appear to justify themselves on a mix of those suggested above: a) state and local officials ignore benefits that spill over jurisdictional lines, b) the Federal fisc could correct interstate imbalance between needs and capacities. and c) the distribution of expenditures within local districts is less sensitive to the interests of the

powerless and the minorities than Federal grantors. All of these appeared to have justified the acknowledged high cost of administering the system of transfers--negotiating applications and monitoring.

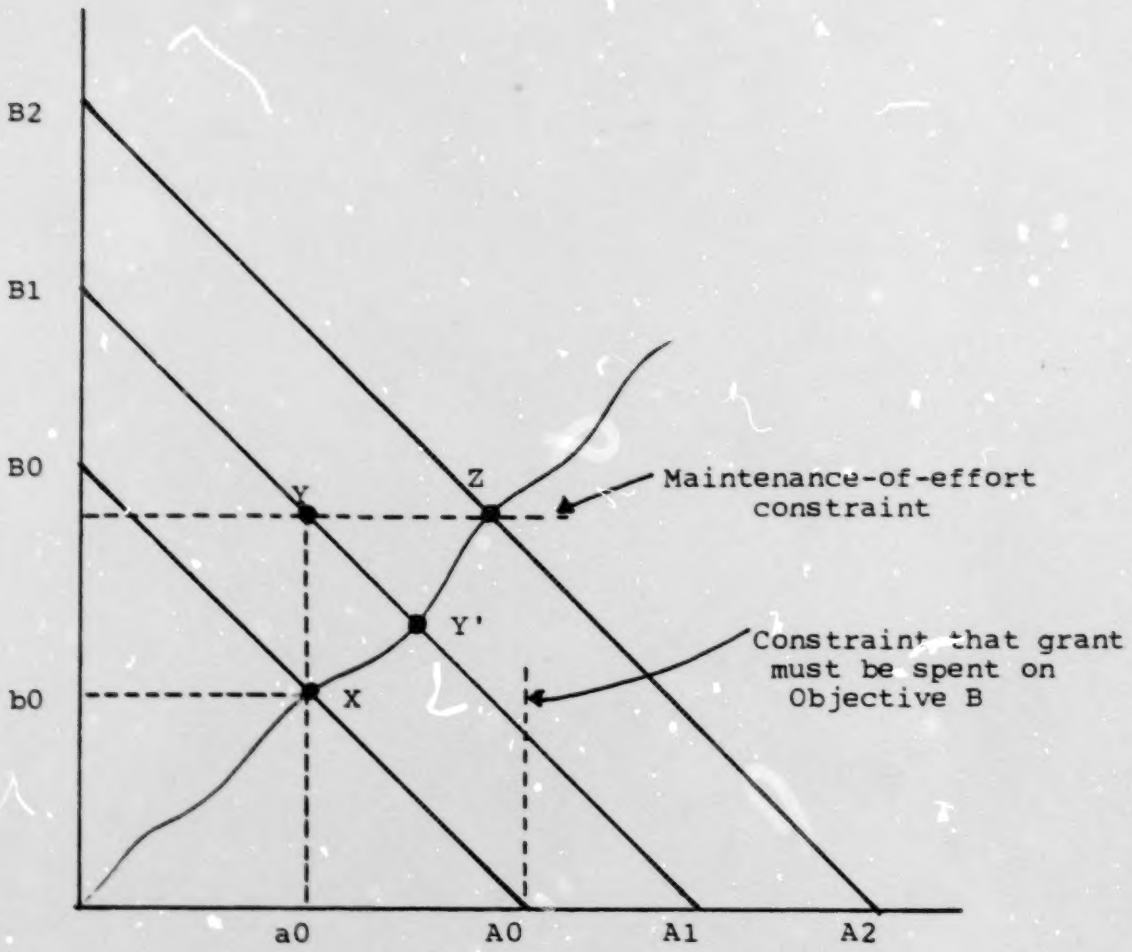
The effects of intergovernmental transfers

A second question about fiscal federalism is "What is the effect of grants for category X on total public expenditures in category X?" Federal grants devoted to a certain category do not necessarily increase expenditures in that category by the amount of the grant. Whether this is the case depends upon the structuring of the financial transfers and the convergence betweent the preferences of the grantor and the grantee.

Most intergovernmental transfers are categorical. For example, of the $50 billion distributed to states and localities by the Federal government, only $6 billion were unconditional, general revenue sharing grants (Herber, 1979, Table 18-1). Categorical grants can vary in the specificity of their targeting. This targeting can focus on program outputs, as broad as "basic skills" or as specific as "English as a second language." The targeting can also focus on items of expenditure as broad as "current educational expenditures" or as narrow as "textbooks." Finally, the beneficiary class can be as broad as "students" or as narrow as "handicapped high school students".

Let us illustrate the consequences of a divergence in preferences between grantor and grantee. Suppose that a given

Figure 1. Expenditure patterns of a school district under different funding systems



community raises a certain amount of local taxes to finance education in time period zero. These funds can be devoted to some mix of objectives A and B. These objectives can refer to program outcomes, such as "basic reading" or "Texas history," or some target groups, such as "the handicapped," or "the gifted." With this budget, as much as A0 of objective A and as much as B0 of Objective B can be obtained, or any combination of the two represented by the line A0B0. As revealed by the political process, the community's prefered mix is indicated by X, which represents a0 units of Objective A and b0 units of Objective B. As the community's income rises over time, it will aim for the expenditure mix on the expansion path OXZ (Figure 1).

Now suppose the community receives an unrestricted flat grant for education. This means that the community could purchase as much as A1 of Objective A and B1 of Objective B. It will treat this grant as if it were an increase in its own tax revenues and spend the funds on mix Y'. Policymakers in Washington view this choice with dismay, because they would have preferred all of the funds to be devoted to Objective B, which has benefits for extra-local constituencies.

In the next round, constraints are placed on the grant. The grant must be spent on objective B only This means that the community's budget line is slightly different from before. Positions to the right of A0 are no longer attainable. If the community simply has to verify that it is spending amount B0B1 on objective B, then this constraint is not binding. Old expenditures on this objective can simply be reclassified so that for

accounting purposes the requirements are met. The community then reduces the expenditure of its own funds on Objective B and increases them on Objective A, ending up at its desired point Y'.

Exasperated by this accounting ruse, the Federal administrators add another constraint, that of "maintenance of effort." The community is now subject to more vigorous monitoring and reporting requirements. Faced with the twin constraints of spending all the Federal grant on objective B and maintaining their earlier effort, the community has no alternative to reaching expenditure mix indicated by Y, which is off its preferred expansion path. The necessity for these constraints are proportional to the divergence between the objectives of the national and local policymakers.

Let us take this community through one more time period. As its income grows, the community raises more taxes and finds itself on budget line A2B2. Its preferred situation is at point Z, which is on its desired expansion path. The community can now move back to its preferred expansion path by spending nearly all of the revenue increase on Objective A. We can say that the Federal constraint is no longer binding and the "money mixes."

In this era of fiscal distress, the concept of rising budgets may seem fanciful. While rising real budgets may be fanciful, rising nominal or money budgets in the past decade and a half of inflation were common. Inflation makes the appearance of "maintenance of effort" effortless.

We are now in a position to state several testable hypotheses about intergovernmental tranfers. Money is more likely to mix:

Figure 2. Maintenance-of-effort constraints binding when intergovernmental transfers are large

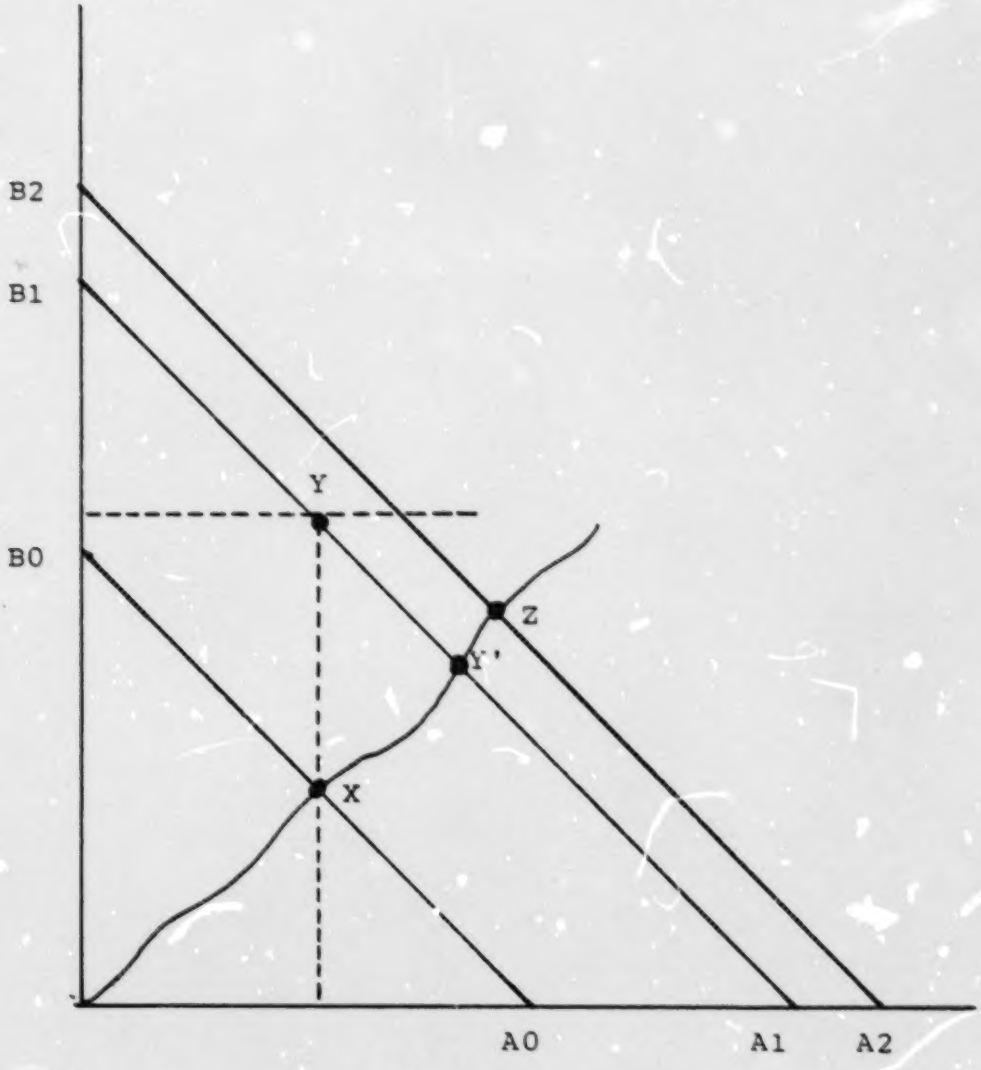
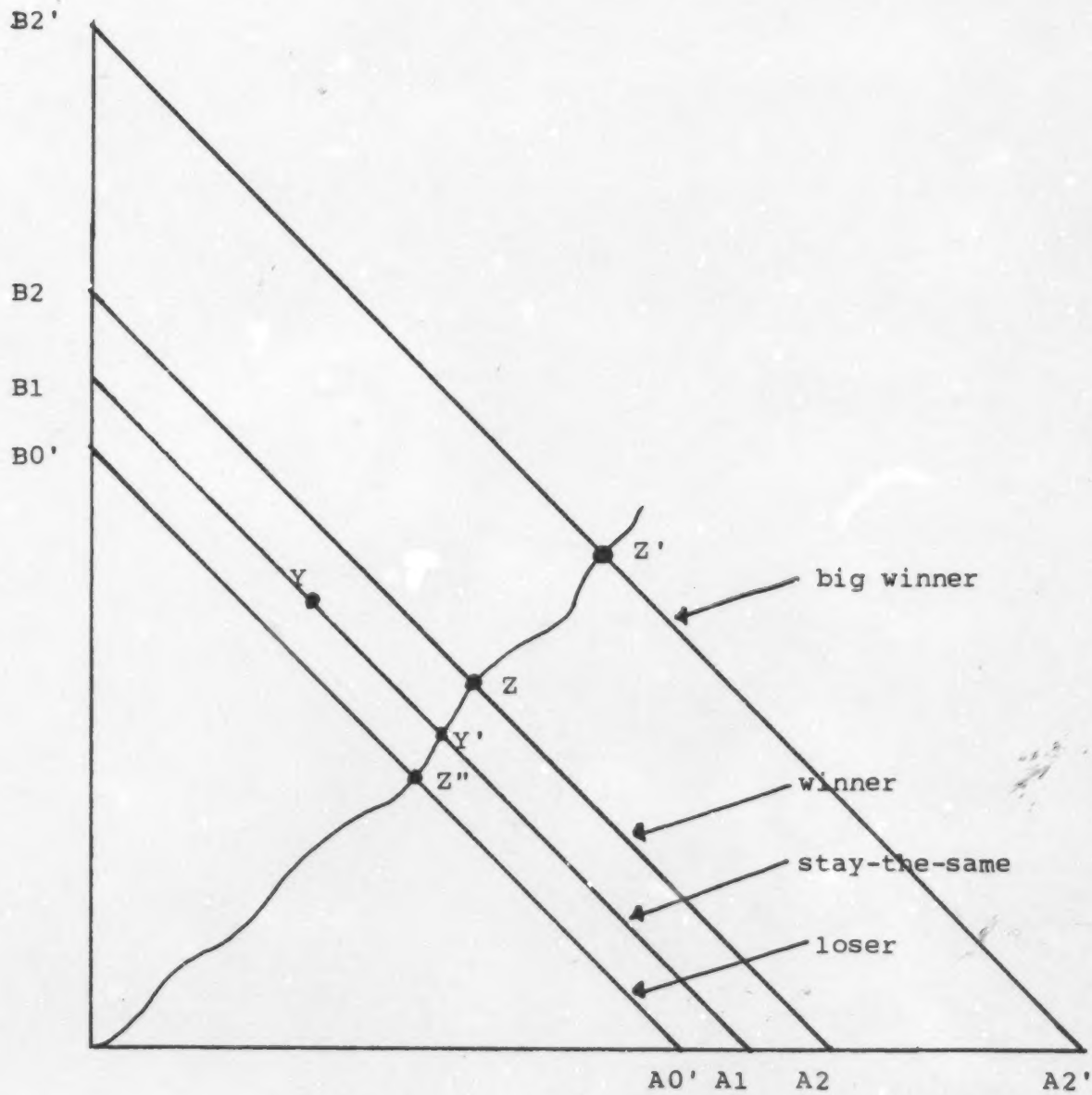


Figure 3. Effects of relaxing the constraints on districts that win, lose, and stay the same



1) the smaller the divergence between the preferences of the Federal grantor and the local grantee.

2) the smaller the injection of Federal funds. and

3) the broader the definition of the category.

If the injection of funds is so large relative to the annual increments a community could raise by its own means and if the preferences of the grantor and grantee diverged significantly the constraints are indeed binding (Figure 2).

Let us now consider the effect of abandoning constraints in three types of communities: those that gained funds in the aggregate, those that stayed the same, and those that lost funds. If the categorical program were so narrow and so divergent from what the community wanted, then it is possible that this program would have never been funded at even extraordinary revenue levels. In this case, the categorical grant program is clearly stimulative and a relaxation of the constraints might lead to its abandonment now matter whether funds were gained or lost.

In winning districts, it is possible that the programs formerly targeted for Objective B would survive and even expand, if the formerly targeted program were close to the expansion path originally. For example, if the bloc grants brought the community budget line up to $A'B'$ (Figure 3), the community may choose to spend more on both objectives. On the other hand, the programs might be maintained at their current levels or abandoned. The fact of its abandonment would reveal that the categorical program served objectives that would not have ordinarily been served by the community.

In districts where funding remained the same, it is possible but not likely that the programs aimed at Objective B would survive intact. The community would move from Y to Y' on budget line A1B1.

In districts where funding fell. programs aimed at Objective B will suffer cutbacks. The cutback drops the community down to budget line A0'B0', and its desired position moves tc X'. Paradoxically, the cutbacks exceed the loss of funds. This is because, the community may still wish to increase its expenditure on Objective A, which can be realized only with additional cutbacks in Objective B.

To the extent that the constraints of the categorical grant system specified particular items of expenditure (e.g. teacher aides from the Title I neighborhood), the relaxation of constraints may lead to a greater reduction in earmarked items of expenditure than to objectives served by these expenditures. In other words. grantees may choose different production technologies to achieve Objective B than specified under the categorical grant system. This shift in production technique may lead a casual observer to overestimate the cutbacks in programs aimed at Objective B.

While we can predict that the relaxation of categorical constraints will result in the reduction of spending on categorical programs, we cannot easily evaluate this result. Each community may feel that the relaxation of constraints makes it better off. but may suffer as constraints on others are relaxed. This is because of the external benefits of some educational

expenditures. For example, each community may benefit from easy communication if all others had efficient programs for teaching English (or French) as a second language, yet may prefer to spend its own funds on other objectives. The behavior of cutting back on a program that you wished other people would maintain is not paradoxical at all. Indeed the external benefits are the reason why categorical programs were Federally funded in the first place. It is too early to decide whether we are pleased by what each community does with its newfound freedoms.

INSIGHTS FROM CONSUMPTION THEORY

The analysis above can be amplified by focusing on items of expenditure which are funded by intergovernmental transfers. Consumption theory attempts to explain patterns of consumer expenditures. In addition to income and price, two important influences on these patterns are the perceived stability or permanence of the income and the hidden costs of consumption.

Public school expenditures can be viewed as a form of public consumption. If a consumer receives an increase in income that is perceived as permanent, then a wide range of expenditures increase--housing, transportation, clothing, among others. This is not to say, that a 5 percent raise immediately translates into a better house, fancier car, and new wardrobe. The wardrobe may be replaced immediately, but the car may not be replaced until the old one wears out, and house hunting may take several years. It may take a consumer several years to completely adjust his lifestyle. If the increase in income were seen as transitory, such

as resulting from a one-time tax cut, consumer behavior is quite different. A transitory income increase is generally expended on consumer durables, such as a new televis[illegible]r piece of jewelry. A durable provides consumption benefits fo[illegible] long period of time, without requiring major recurring expenditures.

The expenditure of Chapter Two funds is indicative of local expectations about the permanence of this program. The perception of Chapter Two as transitory would discourage districts from making commitments to multi-year expenditures in funds that might be entailed in strategies like increasing teacher salaries or reducing class size. Instead, a district which gained funds might devote them to a durable good with little recurring maintenance costs, such as a microcomputer. Even if Chapter Two were cancelled tomorrow, the winning district would have made an investment that could pay off for many years.

There are always hidden costs of consumption. These include the time and effort to make a purchase and consume the good. These costs can be so high, that consumers frequently reject "free offers." Categorical programs were perceived to involve substantial hidden costs in negotiation, monitoring, and reporting. If the potential grants or the probability of obtaining such grants were small, then participation might be low. This would be the case of a small district faced with a competitive, project grant system. A formula-based grant system would minimize the hidden costs and encourage participation. The shift from competitive categorical grants for projects to formula-based

grants might then be expected to increase the participation rate.

IMPLEMENTATION OF CHAPTER TWO IN TEXAS

The dominant political culture of Texas idealizes "small" government and local control rather than big government and centralized direction. Economy in administration rather than the provision of a broad spectrum of public services have been the focal concerns. The state imposes grave restrictions on the ability of the state and localities to incur debt and levy taxes. Texas is one of the few industrial states with a biennial, part-time legislature. Executive power is highly diffused among large numbers of boards, whose positions cannot be completely filled during the term of a governor. The philosophy behind ECIA is quite consistent with these dominant values, and the New Federalism in education was welcomed by state officials.

Rooted in a one-party past. Texas politics has had a consensual rather than confrontational style. In this system, the posture toward minorities (blacks and Hispanics) not fully incorporated into the political process was paternalistic. They would be represented by "responsible civic leaders" who appreciated the complexities of business and government. At the local level, this style is particularly strong in cities which have non-partisan, at-large council elections, weak mayors, and part-time, lowly-paid councillors. In Dallas, one wag claims that the difference between a responsible civic leader and a "politician" that caters to narrow interests is membership in the Bent Tree Country Club. This style is becoming increasingly

untenable as ethnic minorities become incorporated in the political process and as immigrants from other regions bring new political assumptions.

Nevertheless. the development of the formula for sharing ECIA funds reflects this old style. The Blue Ribbon advisory committee consisted of responsible civic leaders from all over the state. All participants in the process clearly recognized that the New Federalism would reduce the connection between entitlements and "need." The development of the formula was relatively depoliticized. The fact that the state legislature was not in session during 1982 may have contributed to the calm. Alternative formulas were proposed by the state education agency for consideration. A formula was selected with the aim of maximizing the returns of "needy" districts. namely Austin, Dallas. and Houston. which were in the throes of a costly desegregation process. In addition the state used some of its funds for magnet schools in these districts.

Aside from its symbolic benefits, the Chapter Two innovation is viewed largely as a non-event because of the small sums involved. Rather than seeing ECIA as a new cornucopia. one state official views it as a Shakespearean play, "Much Ado about Nothing." Another calls it an "aborted pygmy."

Despite these unkind cuts. a cursory examination of the Texas experience reveals several dramatic impacts:

1. The participation rate of school districts and private schools in Chapter Two was markedly higher than that in the project-based categorical programs that were replaced. Under the Old Federalism,

only 79 of the states 1099 districts received funds. Few private schools had participated, mainly because they were unwilling to subject their admissions policies to external scrutiny. Clearly. the hidden transactions cost of applying and administering a grant appeared prohibitive before. Now virtually all public school districts apply and private school participation is rising rapidly.

2. Since more than 1000 public school districts are getting funds for the first time, the vast majority of districts are winners. Of the 2.6 million school children in the state. nearly 2 million attend winning districts.

3. The big losers are those districts which have been under court orders to desegregate and which formerly received funds under the Emergency School Assistance Act (ESAA). Most of the losses are accounted for by Austin, Dallas. and Houston. Fifteen other smaller districts. not under court order. but receiving ESAA funds lost as well. These big losers enroll about 500 thousand students.

4. Only a few districts ended up with virtually the same funding before and after Chapter Two. The largest of these is San Antonio, which has an enrollment that is over two-thirds Hispanic.

5. As suggested by the theory of consumption, the adjustment to Chapter Two is not yet complete. Many districts that have lost funding are maintaining programs formerly funded by categoricals by carryover funds and some local funds. albeit at a lower level. Since budgets for school year 1982-83 were prepared before Chapter Two allocations were known, some communities may make upward or downward adjustments in their local tax rates in

the future.

6. The winners spent virtually all of their gains on durable goods and services; i.e. microcomputers and teacher training to use these newfangled devices. This expenditure can be viewed as: a) an indicator that Chapter Two funds are viewed as a transitory windfall; b) a rational response to an earth-shaking new technology; or c) both. Like those elsewhere, Texas schools are moving heavily into microcomputers on their own account. Expenditures on these items far exceed Chapter Two funds. so interpretation (c) seems most plausible. In other words. Chapter Two funds are enabling districts to move toward this new technology faster.

7. Districts that have lost categorical grants are cutting back on programs they formerly funded. This appears to be the case even in districts that have on the aggregate stayed the same or even gained funds. One can infer that many projects in the past were operated by local districts because the categorical grant money was available. When the link between specific projects and intergovernmental transfers are broke. these projects may appear less desirable from a point of view of their efficiency, their objectives. or their beneficiary population.

If the redirection of funds improves efficiency in meeting the same objectives and in serving the same beneficiary population. then a clear gain results. In other words. the locals are no longer hamstrung by regulations which force them through contortions to meet Federal input constraints. For example, one district perceived that it could use its Chapter Two funds for

after-school remedial work, but could not do so with categorical funds. which required expenditure during normal school hours. Whether the after school program is more efficient than in-school program merits further research, but some schools have felt that they now had the means to test new alternatives.

In some cases, there has been a clear case of shifting beneficiary classes. Dropping a "cross-cultural center" for minority children undergoing integration for purchasing microcomputers represents a shift of immediate benefits from some of the poorest children to all children. This does not say that poor minority children will not benefit more from microcomputers than from "cross-cultural centers." Again, analysis of the distribution of benefits merits further research on outcomes.

CONCLUSION

In January 1983, a new governor and legislature took office. The governor must replace the now-vacant Chapter Two Advisory Committee and the new legislature will have to deal with the prospects of an unprecedented $1 billion deficit, pressures to provide compensatory assistance to a few districts that have lost ESAA funds. The story of implementation is not yet complete.

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